Royal London Diversified Asset-Backed Securities Fund

Quarterly Report 31 March 2022

Asset split

	Fund (%)
Conventional credit bonds[2]	94.4
Index linked credit bonds	0.2
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.3
Foreign index linked sovereign	0.0
Derivatives	5.1
Other	0.0

Fund data

	Fund
Duration[3]	0.3 years
Gross redemption yield[4]	3.29%
No. of stocks	222
Fund size	£202.4m

Source: RLAM, based on the Z share class. Launch date: 24.09.2012.
[1]Benchmark: SONIA.
[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[3]Excluding cash
[4]The gross redemption yield is calculated on a weighted average basis

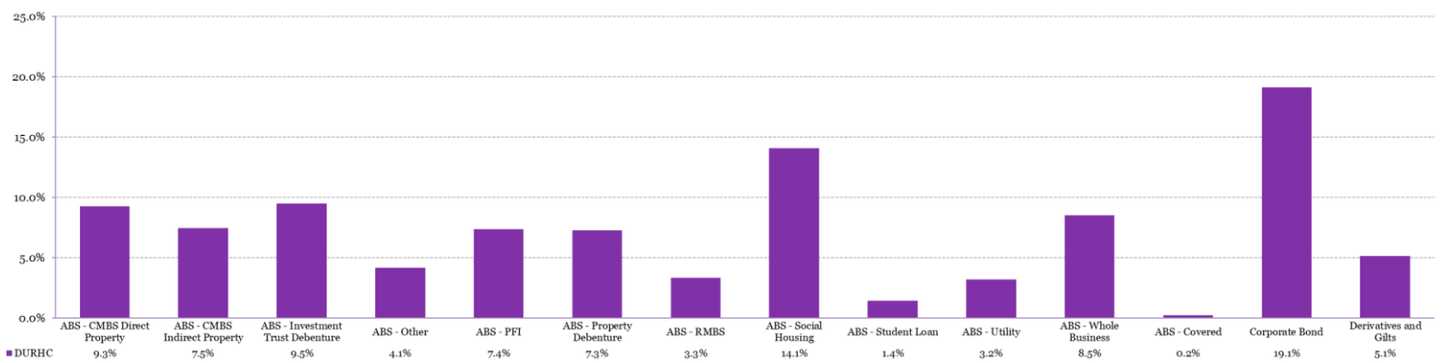
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q1 2022	**0.14**	**0.10**	**0.04**
Year-to-date	0.14	0.10	0.04
Rolling 12 months	4.10	0.14	3.97
3 years p.a.	3.84	0.30	3.53
5 years p.a.	3.68	0.42	3.26
Since inception p.a. 24.09.2012	4.09	0.47	3.62

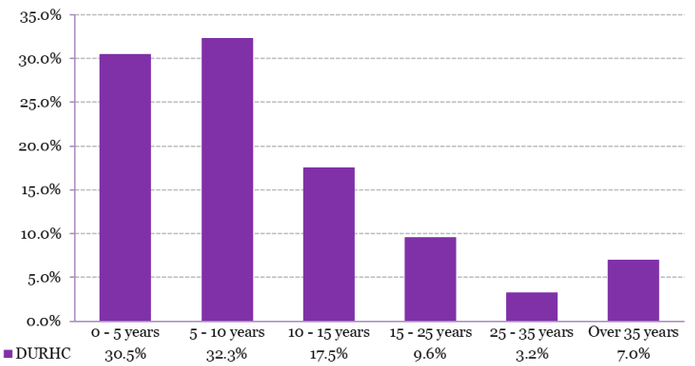
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.
Source: RLAM, based on the Z share class.
Please note that fund name was changed from RL Duration Hedged Credit Fund on 21 December 2020, and the objective amended, while the benchmark of that fund changed from 3-month LIBOR to SONIA, effective 8 August 2019. Both changes are reflected in the returns shown above.
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Sector breakdown

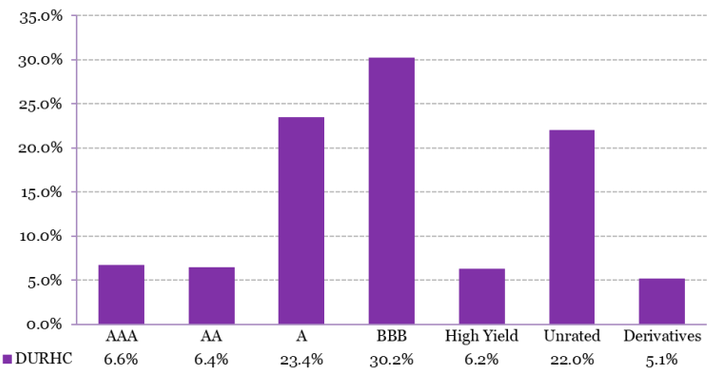


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Scottish Mortgage 6.875% 2023	1.9
Telereal Securitisation FRN 2033	1.6
British Land Co 5.264% 2035	1.6
Edinburgh Investment Trust 7.75% 2022	1.5
Trafford Centre 2038	1.4
Finance for Residential Social Housing 8.368% 2058	1.2
Mercantile Investment Trust 6.125% 2030	1.2
Grosvenor UK Finance 6.5% 2026	1.2
Law Debenture 6.125% 2034	1.2
Equity Release 5.7% 2031	1.1
Total	**13.9**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

Market overview

- Russia's invasion of Ukraine in late February was met by a unified response from Western powers, enforcing far reaching economic sanctions. Although a sense of calm has returned to markets, the unpredictability of war means that this may not continue.
- After the relatively benign impact of the Omicron variant of Covid-19, central banks globally maintained the hawkish pivot taken into the turn of the year, as they focused on tackling higher than expected inflation rates. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and the increase to sterling investment grade yields in the period was driven mainly by underlying gilts yields, although spreads have also widened.
- War in Ukraine has exacerbated inflationary pressures. Rising commodity prices are driving up the cost of energy, food, and materials, leading to a further squeeze on real disposable incomes. This is being compounded by higher interest rates, giving rise to concern about future economic growth. Bank of England (BoE) Governor Bailey cited such concerns during the March Monetary Policy Committee (MPC) meeting but increased the interest rate nonetheless; the UK base rate stood at 0.75% at the end of the reporting period, after consecutive 25bps hikes in February and March.
- The UK's Spring Budget Statement saw some measures to limit the impact of forthcoming tax rises, mitigating around one third of impact of rising costs on consumers. Markets are still pricing in seven rate hikes in the UK over the next twelve months, taking the base rate towards 2.5%. In the US, where the economy is better insulated from rising commodity prices (it is a net energy exporter) the Federal Reserve (the Fed) doubled down on its hawkish stance on inflation, highlighting the potential for a diversion in monetary policy between central banks going forward. The Fed ended its quantitative easing (QE) programme at the end of March, as planned, and markets are now pricing eight rate hikes in 2022, which would see the target rate reach around 2.5% by year end.
- In the UK, the benchmark 10-year gilt yield rose from 0.97% to 1.61% in the quarter, a rise of 64bps. There was a respite in the upwards trend following the Russian invasion of Ukraine but concern about inflation and more hawkish central bank rhetoric meant that the fall in yields proved to be temporary. The same pattern was visible in the US and Germany, where yields rose throughout the period but temporarily dipped around the onset of war in Ukraine: in the US, the benchmark 10-year US treasury yield rose from 1.51% to 2.34% in the quarter, while the German 10-year bund yield rose from -0.14% to 0.55%.
- The first quarter of 2022 was the worst performing quarter for sterling credit markets (-6.2%) since the Global Financial Crisis. Although broad sterling credit indices outperformed government bonds this reflected their lower duration, as investment grade spreads widened by 22bps (iBoxx Sterling Non-Gilt index). Defensive sectors such as supranational, covered and asset backed outperformed, whilst financials (banks and insurance) were laggards, particularly subordinated bonds when looking at excess returns (adjusted for the impact of duration). Some energy bonds were weak despite the rise in oil and gas prices, reflecting exposures to Russia. By credit rating, AAA rated debt outperformed other investment grade ratings bands; BBB rated debt outperformed A rated debt; and sub-investment grade debt outperformed investment grade markets, albeit still delivering negative absolute returns.
- Sterling credit markets provided negative absolute returns in what was the worse quarter since the Global Financial Crisis. Markets were driven by the significant rise in yields of the underlying gilt market, with nominal gilt yields rising by around 60-70bps across all maturities in the first quarter.

Performance and activity

- The fund performed well in the first quarter, returning 0.14% against 0.10% for its SONIA benchmark. The fund's hedging of duration risk prevented strong negative returns along with the broader sterling credit market, while structured bonds, of which the fund holds a strong preference, performed well relative to the market. The slight negative impact of wider spreads was offset by our security selection and strong carry that these provide.
- Specifically, we saw positive contributions from **General Electric** bonds and some legacy subordinated bank debt, which bucked the general financial trend (e.g., **Santander**, **Lloyds Bank**). In the general industrials sector, the biomass and low carbon heat specialist **Aggregated Micropower** had a particularly strong quarter, while real estate companies **Peel Land** and **Eskmuir** were also notable performers, maintaining their value while the broader real estate sector delivered below market returns. The structured student loans bond **ICSL** was also a standout performer, demonstrating the value of secured lending in uncertain markets.
- In the first two weeks of the quarter sterling credit issuance was extremely strong, helping the market to meet forecast expectations for January even though the latter half of the month proved to be extremely quiet. February was similarly quiet, with the £3.1 billion of issuance in primary

sterling markets nearly 50% below estimates. Issuance picked up again in March, as £6.6bn of new debt was brought to market, only a touch below forecasts. Issuance was, however, skewed heavily in favour of financials, particularly non-domestic banks.

- We participated in a number of new issues. In social housing, we bought another 'use of proceeds' bond from **Peabody Group**, a housing association based in London – proceeds will finance the retrofitting of existing homes to improve energy performance certificate (EPC) ratings and energy efficiency, and to boost the number of electric vehicle charging points throughout its developments. Otherwise, we bought new issues from **Housing & Care 21** and **Flagship Finance**. We also bought a sterling issue from US real estate investment trust **Realty Income** adding diversification through exposure to non-UK revenues. In utilities we bought an issue from **Bazalgette**, a green bond where the proceeds are used to build London's 'super sewer,' delivering extensive environmental benefits. Also in the utility sector, we bought new issues from **Northern Powergrid,** continuing our preference for regulated electricity providers. Finally, we were particularly active in the senior banks sector, picking up a number of new issues at good value. We added new issues from **Santander**, **BNP Paribas** and **NatWest**.
- In the secondary market, we were particularly active in the structured and real estate sectors. Market volatility in the quarter allowed us to pick up some bonds that have been more difficult to source, at the right price, last year. We added to **Telereal, Arqiva Finance, ICSL, Dignity Finance, Longstone Financial,** and the **Trafford Centre** in the period. In real estate, we added to holdings including **British Land**, and widely priced debentures **Shaftesbury Chinatown,** and **Shaftesbury Carnaby.**
- There were no defaults in the portfolio during the quarter and across the corporate sector failures remain at low levels. While defaults are likely to increase from the current very low levels as we transition back to more normal economic conditions, we believe that the fund is well positioned for this. The fund has a material exposure to BBB bonds where compensation for default risk remains elevated and losses are further dampened by security, strong covenants and, in the majority of cases, a senior claim on issuers' assets and cashflows. Credit risk is not something that should be taken unthinkingly but it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.
- Our credit philosophy is based on the sustainability of our lending position over the long term. Environmental, social and governance (ESG) integration has to be a part of this consideration: these factors can play a part in determining the financial future of a company and are therefore integral for any effective assessment of credit risk. We continue to believe that lending on a senior secured basis, with strong covenants, can have a dampening effect on rising governance-related risks for a large part of the fund. From an environmental perspective, we continue to carry out bespoke engagement with issuers, with further detail available in our ESG integration report.

Key views within the portfolio

- A bias towards senior asset backed securities, an area that we believe still offers the best risk/return characteristics.
- Very limited exposure to junior tranches of securitisations, where downgrade, loss and extension risks are heightened.
- Selective exposure to unsecured debt (less than 20% of the corporate bond element), targeted at well-regulated financial debt and undervalued corporate debt.
- Zero exposure to supranational bonds, as we expect secured debt and corporate debt to outperform over the medium term.
- An exposure to credit risk with minimal exposure to interest rate risk (hedged with interest rate swaps).

Outlook

- There is considerable uncertainty about the year ahead. The war in Ukraine has worsened existing trends and has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal.
- In the UK, investors are pricing in a move to a 2.5% base rate over twelve months and in the eurozone there has been a significant shift, with tightening now expected in the second half of the year. Although we expect a slowdown in the medium term, we believe that market pricing may be too aggressive at present. However, we must highlight the uncertainty of any market forecasts at present, given the unpredictability of war in Ukraine.
- The widening in credit spreads has taken valuations to attractive levels, relative to government bonds. However, if tensions in Ukraine intensify, we would expect further modest widening in investment grade and high yield credit spreads. Nevertheless, at current levels, investment grade spreads over-compensate for default risk, and we expect that credit will outperform government debt over the medium term.

Our portfolios have a material exposure to BBB bonds but we believe that compensation for default risk remains most attractive for the bonds that we hold in this rating band.

- The Bank of England announced in the quarter that it will sell its holdings of corporate bonds. While the BoE's buy programme had a significant (if only temporary) impact on sterling credit markets, we do not expect the same for the sale. Although the holding is material in size, it is not a structurally significant portion of the market, and with the proposed sales timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.
- We will maintain our long-standing focus on risk management by seeking to identify companies with strong balance sheets; favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors, and other factors. In addition, we expect to remain in favour of subordinated financial bonds where credit spreads remain attractive.

Find out more

- RLAM recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March.
- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars and other mediums. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.co.uk for further information.

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